

New Developments in IRS Enforcement Strategies

George Plesko

MIT Sloan School of Management



Agenda

- Provide an overview of how the papers fit together
- Highlight the types of problems LMSB is confronting.
- Present some information on corporate return information as it relates to other information on the firm.
 - *Tax avoidance activities and book-tax reporting differences.*
- Provide an example of new information to incorporate in these models,
 - *M-3*
 - *Financial disclosure*

What is the IRS Up Against?

- Tax avoidance activities which are complex in design and implementation.
 - Multiple entities, multiple types of entities, multiple tax years.
 - Design incorporates how, when, and where the transaction will be reported.
 - Designers have some knowledge of IRS procedures and tools.
- In the case of publicly-traded corporations, may yield asymmetric reporting of gains/losses.
- Deferral is intended to be forever.
 - *Ideal tax shelter affects only tax reporting, and creates a permanent reporting difference.*

The Papers

Compliance Risk Modeling and Resource Allocation in LMSB

William B. Trautman

Detecting Abusive Tax Avoidance Transactions Using Support Vector Machines

DeBarra and Harwood

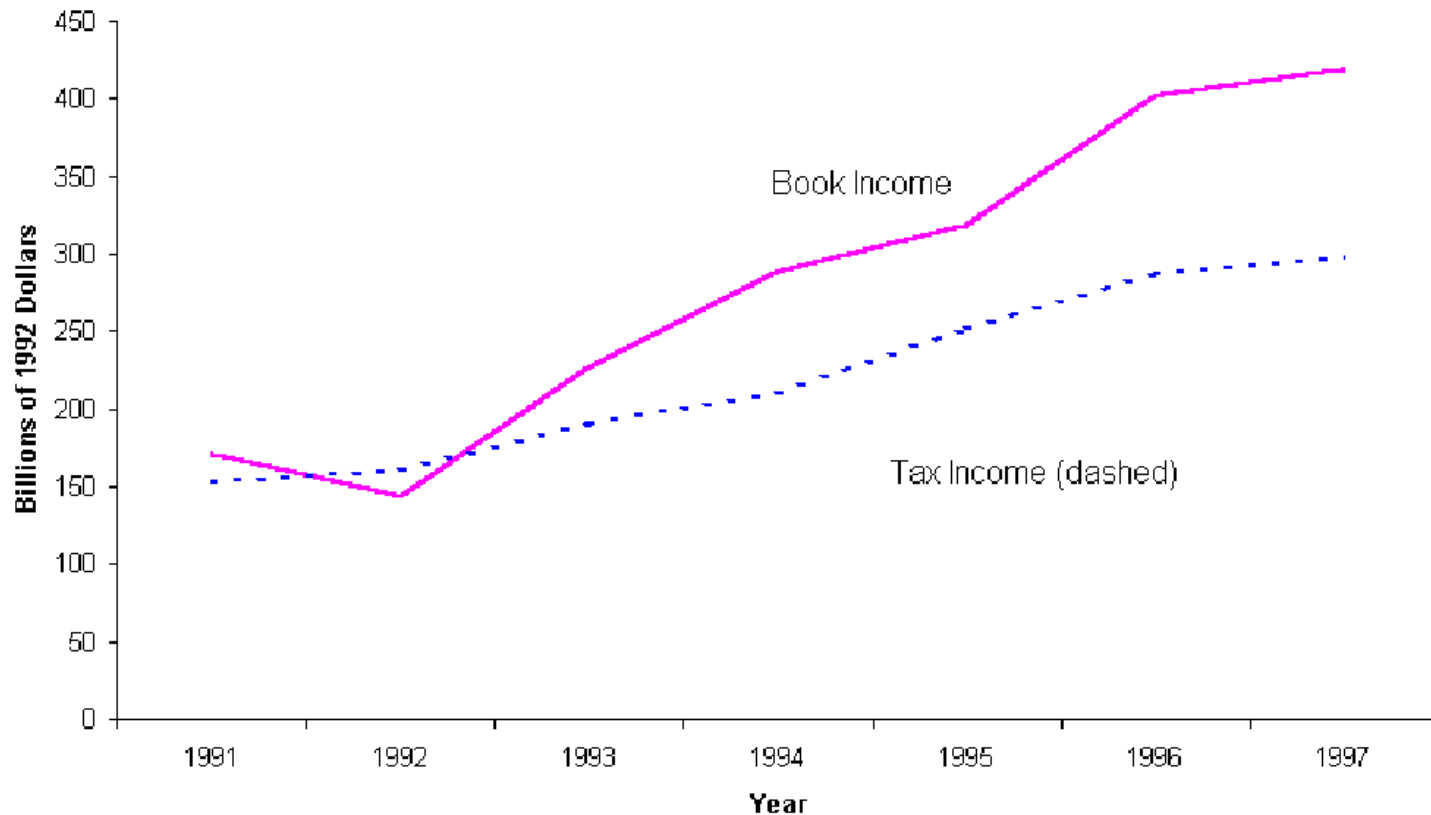
Designing a System for Structured Assessment of Compliance Risk

Lawrence and Ragoobeer

What are Book-Tax Differences?

- Book-tax differences are caused by differences in tax and financial accounting for income and expenses (deductions).
 - Tax depreciation is generally faster than book depreciation, leading to less income in the short-term, but more income later. This is a *temporary* difference.
 - Tax-exempt interest is not included in taxable income, but is income for financial reporting purposes. This is a *permanent* difference.
- New Schedule M-3 will require better and more detailed reporting of these differences.

Figure 1.
Book and Tax Corporate Income
Firms with Mean Assets Over \$1 Billion



Book Income = After-tax book income from Schedule M-1 + Federal taxes - tax exempt interest

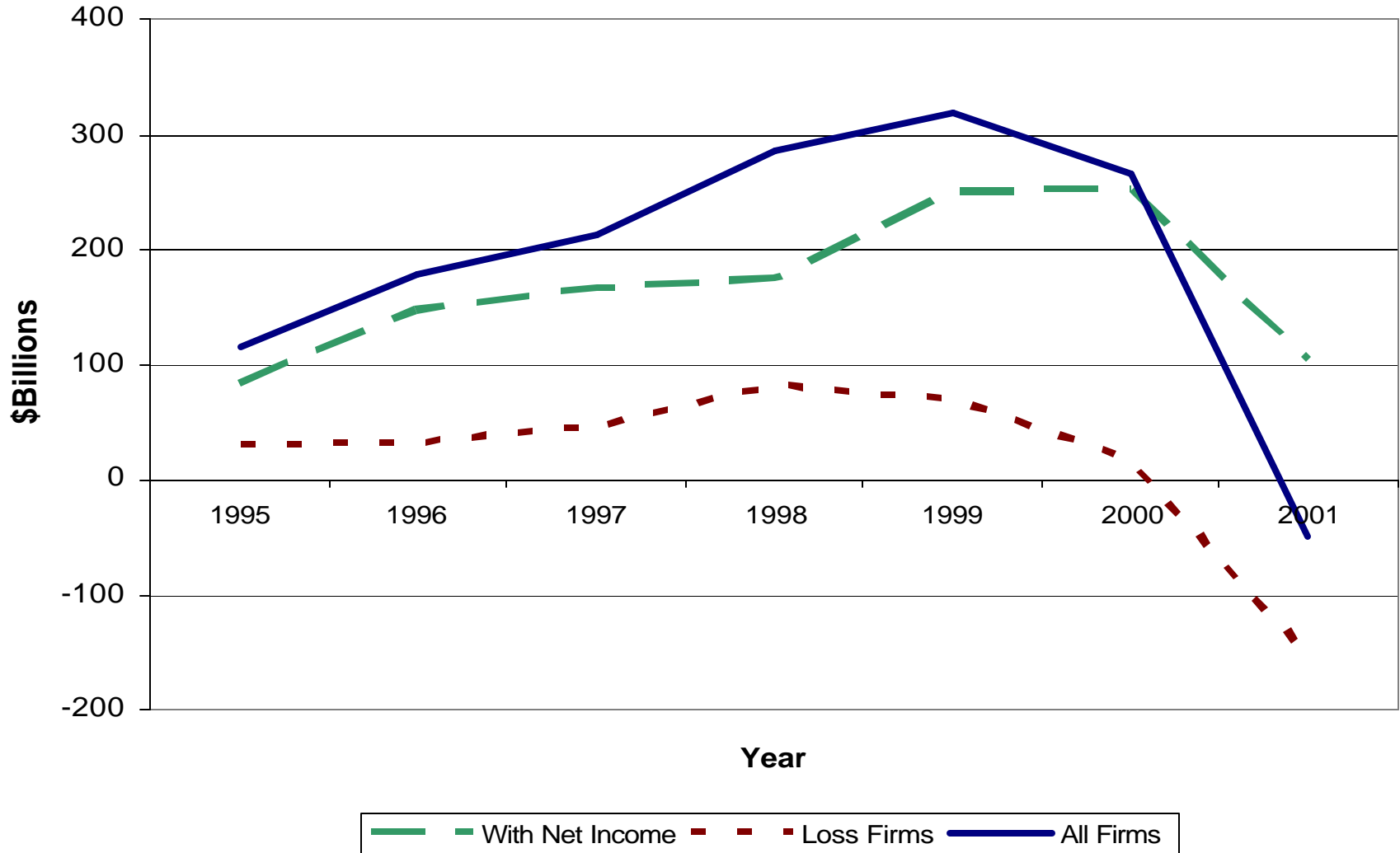
Tax Income = Total Receipts - Total Deductions

Corporations excluding S corporations, RICs, REITs, and Foreign Corporations

Source: Internal Revenue Service, Statistics of Income

Source: US Treasury (1999)

Book-Tax Reporting Differences, 1995 - 2001



Maintaining Competitiveness

The professional skill and experience of IRS enforcement employees are [the] most valuable IRS resource. Improved collaboration and accumulation of an accessible “corporate memory” of complex issue & entity risk assessment will improve employee effectiveness and satisfaction.

-Lowrance and Ragoobeer

Conclusions

- Interesting set of papers
- This is a tough area to try to make advances that outpace the technology arrayed against you.
- Great to see the extent that the IRS is developing technology and strategies to keep up.
- Complements, and will benefit from, increased reporting.